

§ 1.902-2

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§ 1.902-2 Treatment of deficits in post-1986 undistributed earnings and pre-1987 accumulated profits of a first- or lower-tier corporation for purposes of computing an amount of foreign taxes deemed paid under § 1.902-1.

(a) *Carryback of deficits in post-1986 undistributed earnings of a first- or lower-tier corporation to pre-effective date taxable years*—(1) *Rule*. For purposes of computing foreign income taxes deemed paid under § 1.902-1(b) with respect to dividends paid by a first- or lower-tier corporation, when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first- or lower-tier corporation with positive accumulated profits computed under section 902. See § 1.902-3(e). For purposes of this § 1.902-2, a pre-effective date taxable year is a taxable year beginning before January 1, 1987, or a taxable year beginning after December 31, 1986, if the special effective date of § 1.902-1(a)(13) applies. The deficit shall reduce the section 902 accumulated profits in the most recent pre-effective

date year to the extent thereof, and any remaining deficit shall be carried back to the next preceding year or years until the deficit is completely allocated. The amount carried back shall reduce the deficit in post-1986 undistributed earnings. Any foreign income taxes paid in a post-effective date year will not be carried back to pre-effective date taxable years or removed from post-1986 foreign income taxes. See section 960 and the regulations under that section for rules governing the carryback of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations.

(2) *Examples*. The following examples illustrate the rules of this paragraph (a):

Example 1. (i) From 1985 through 1990, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1985	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A.	150u	150u	(100u)	100u	0	0
Current Plus Accumulated E & P of Corp. A.	150u	300u	200u	250u	250u	200u
Post-'86 Undistributed Earnings of Corp. A.			(100u)	100u	100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).			0	100u	50u	50u
Foreign Income Taxes of Corp. A (Annual).	120u	120u	\$10	\$50	0	0
Post-'86 Foreign Income Taxes of Corp. A.			\$10	\$60	\$60	\$30
12/31 Distributions to Corp. M	0	0	5u	0	5u	0
12/31 Distributions to Corp. Z	0	0	45u	0	45u	0

(ii) On December 31, 1987, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has a deficit of (100u) in post-1986 undistributed earnings and \$10 of post-1986 foreign income taxes. The (100u) deficit (but not the post-1986 foreign income taxes) is carried back to offset the accumulated profits of 1986 and removed from post-

1986 undistributed earnings. The accumulated profits for 1986 are reduced to 50u (150u-100u). The dividend is paid out of the reduced 1986 accumulated profits. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are 12u (120u×(5u/50u)). See § 1.902-1(b)(3). Corporation M must include 12u in gross income (translated under the rule applicable to foreign income taxes

paid on earnings accumulated in pre-effective date years) under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from Corporation A, a noncontrolled section 902 corporation. No accumulated profits remain in Corporation A with respect to 1986 after the carryback of the 1987 deficit and the December 31, 1987, dividend distributions to Corporations M and Z.

(iii) On December 31, 1989, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 100u of post-1986 undistributed earnings and \$60 of post-1986 foreign income taxes. Therefore, the dividend is considered paid out of Corporation A's post-1986 undistributed earnings. Foreign taxes deemed paid by Corporation M with respect to the 5u dividend are \$3 ($\$60 \times 5\% [5u/100u]$). Corporation M must include \$3 in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1990, are 50u ($100u - 50u$). Corporation A's post-1986 foreign income taxes must be reduced by the amount of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes. Section 1.902-1(a)(8)(i). The amount of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend distributed by Corporation A is \$30 ($\$60 \times 50\% [50u/100u]$). Thus, post-1986 foreign income taxes as of January 1, 1990, are \$30 ($\$60 - \30).

Example 2. The facts are the same as in *Example 1*, except that Corporation A has a deficit in its post-1986 undistributed earnings of (150u) on December 31, 1987. The deficit is carried back to 1986 and reduces accumulated profits for that year to -0-. Thus, the foreign income taxes paid with respect to the 1986 accumulated profits will never be deemed paid. The 1987 dividend is deemed to be out of Corporation A's 1985 accumulated profits. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend paid on December 31, 1987, are 4u ($120u \times 5u/150u$). See § 1.902-1(b)(3). As a result of the December 31, 1987, dividend distributions, 100u ($150u - 50u$) of accumulated profits and 80u ($120u$ reduced by $40u [120u \times 50u/150u]$) of foreign taxes that would have been deemed paid had all of Corporation A's shareholders been eligible to compute an amount of foreign taxes deemed paid with respect to the dividend paid out of 1985 accumulated profits) remain in Corporation A with respect to 1985.

Example 3. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits and post-1986 undistributed earnings or deficits in post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990	1991
Current E & P (Deficits) of Corp. A.	100u	(50u)	150u	75u	25u	0
Current Plus Accumulated E & P of Corp. A.	100u	50u	200u	175u	200u	80u
Post-'86 Undistributed Earnings of Corp. A.		(50u)	100u	75u	100u	0
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (increased by deficit carryback).		(50u)	0	75u	0	0
Foreign Income Taxes (Annual) of Corp. A.	80u	0	\$120	\$20	\$20	0
Post-'86 Foreign Income Taxes of Corp. A.		0	\$120	\$20	\$40	0
12/31 Distributions to Corp. M	0	0	10u	0	12u	0
12/31 Distributions to Corp. Z	0	0	90u	0	108u	0

(ii) On December 31, 1988, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$120 in its post-1986 foreign income taxes. Corporation M is

deemed, under § 1.902-1(b)(1), to have paid \$12 ($\$120 \times 10\% [10u/100u]$) of the post-1986 foreign income taxes paid by Corporation A and includes that amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid

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are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. Corporation A's post-1986 undistributed earnings as of January 1, 1989, are 0 (100u-100u). Its post-1986 foreign taxes as of January 1, 1989, also are 0, \$120 reduced by \$120 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of foreign taxes deemed paid on the dividend from Corporation A ($\$120 \times 100\% [100u/100u]$).

(iii) On December 31, 1990, Corporation A distributes a 12u dividend to Corporation M and a 108u dividend to Corporation Z. At that time Corporation A has 100u in its post-1986 undistributed earnings and \$40 in its post-1986 foreign income taxes. The dividend is paid out of post-1986 undistributed earnings to the extent thereof (100u), and the remainder of 20u is paid out of 1986 accumulated profits. Under § 1.902-1(b)(2), the 12u dividend to Corporation M is deemed to be paid out of post-1986 undistributed earnings to the extent of 10u ($100u \times 12u/120u$) and the remaining 2u is deemed to be paid out of Corporation A's 1986 accumulated profits. Similarly, the 108u dividend to Corporation Z is deemed to be paid out of post-1986 undistributed earnings to the extent of 90u ($100u \times 108u/120u$) and the remaining 18u is deemed to be paid out of Corporation A's 1986 accumulated profits. Foreign income taxes deemed paid by Corporation M under section 902 with respect to the portion of the dividend paid out of post-1986 undistributed earnings are \$4 ($\$40 \times 10\% [10u/100u]$), and foreign taxes deemed paid by Corporation M with respect to the portion of the dividend deemed paid out of 1986 accumulated profits are 1.6u ($80u \times 2u/100u$). Corporation M must include \$4 plus 1.6u translated under the rule applicable to foreign income taxes paid on earnings accumulated in taxable years prior to the effective date of the Tax Reform Act of 1986 in gross income as a dividend under section 78. The income inclusion and the foreign income taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 Corporation A. As of January 1, 1991, Corporation A's post-1986 undistributed earnings are 0 (100u-100u). 80u (100u-20u) of accumulated profits remain with respect to 1986. Post-1986 foreign income taxes as of January 1, 1991, are 0, \$40 reduced by \$40 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986 undistributed earnings ($\$40 \times 100\% [100u/100u]$). Corporation A has 64u of foreign income taxes remaining with respect to 1986, 80u reduced by 16u [$80u \times 20u/100u$] of foreign income taxes that would have been deemed paid if Corporations M and Z both were eligible to compute an amount of deemed paid taxes on

the 20u dividend distributed by Corporation A out of 1986 accumulated profits.

(b) *Carryforward of deficit in pre-1987 accumulated profits of a first- or lower-tier corporation to post-1986 undistributed earnings for purposes of section 902*—(1) *General rule.* For purposes of computing foreign income taxes deemed paid under § 1.902-1(b) with respect to dividends paid by a first- or lower-tier corporation out of post-1986 undistributed earnings, the amount of a deficit in accumulated profits of the foreign corporation determined under section 902 as of the end of its last pre-effective date taxable year is carried forward and reduces post-1986 undistributed earnings on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, or on the first day of the first taxable year in which the ownership requirements of section 902(c)(3)(B) and § 1.902-1(a)(1) through (4) are met if the special effective date of § 1.902-1(a)(13) applies. Any foreign income taxes paid with respect to a pre-effective date year shall not be carried forward and included in post-1986 foreign income taxes. Post-1986 undistributed earnings may not be reduced by the amount of a pre-1987 deficit in earnings and profits computed under section 964(a). See section 960 and the regulations under that section for rules governing the carryforward of deficits and the computation of foreign income taxes deemed paid with respect to deemed income inclusions from controlled foreign corporations. For translation rules governing carryforwards of deficits in pre-1987 accumulated profits to post-1986 taxable years of a foreign corporation with a dollar functional currency, see § 1.985-6(d)(2).

(2) *Effect of pre-effective date deficit.* If a foreign corporation has a deficit in accumulated profits as of the end of its last pre-effective date taxable year, then the foreign corporation cannot pay a dividend out of pre-effective date years unless there is an adjustment made (for example, a refund of foreign taxes paid) that restores section 902 accumulated profits to a pre-effective date taxable year or years. Moreover, if a foreign corporation has a deficit in section 902 accumulated profits as of the end of its last pre-effective date taxable year, then no deficit in post-

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1986 undistributed earnings will be carried back under paragraph (a) of this section. For rules concerning carrybacks of eligible deficits from post-1986 undistributed earnings to reduce pre-1987 earnings and profits computed under section 964(a), see section 960 and the regulations under that section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. (i) From 1984 through 1988, domestic corporation M owns 10 percent of the

one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays pre-1987 and post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1984	1985	1986	1987	1988
Current E & P (Deficits) of Corp. A	25u	(100u)	(25u)	200u	100u
Current Plus Accumulated E & P (Deficits) of Corp. A	25u	(75u)	(100u)	100u	50u
Post-'86 Undistributed Earnings of Corp. A				100u	50u
Post-'86 Undistributed Earnings of Corp. A Reduced By Current Year Dividend Distributions (reduced by deficit carryforward)				(50u)	50u
Foreign Income Taxes (Annual) of Corp. A	20u	5u	0	\$100	\$50
Post-'86 Foreign Income Taxes of Corp. A				\$100	\$50
12/31 Distributions to Corp. M	0	0	0	15u	0
12/31 Distributions to Corp. Z	0	0	0	135u	0

(ii) On December 31, 1987, Corporation A distributes a 150u dividend, 15u to Corporation M and 135u to Corporation Z. Corporation A has 200u of current earnings and profits for 1987, but its post-1986 undistributed earnings are only 100u as a result of the reduction for pre-1987 accumulated deficits required under paragraph (b)(1) of this section. Corporation A has \$100 of post-1986 foreign income taxes. Only 100u of the 150u distribution is a dividend out of post-1986 undistributed earnings. Foreign income taxes deemed paid by Corporation M in 1987 with respect to the 10u dividend attributable to post-1986 undistributed earnings, computed under § 1.902-1(b), are \$10 ($\$100 \times 10\% [10u/100u]$). Corporation M includes this amount in gross income under section 78 as a dividend. Both the income inclusion and the foreign taxes deemed paid are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. After the distribution, Corporation A has (50u) of post-1986 undistributed earnings (100u-150u) and -0- post-1986 foreign income taxes, \$100 reduced by \$100 of foreign income taxes paid that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 100u dividend distributed by Corporation A out of post-1986

undistributed earnings ($\$100 \times 100\% [100u/100u]$).

(iii) The remaining 50u of the 150u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. The 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902-1(b)(4).

Example 2. (i) From 1986 through 1991, domestic corporation M owns 10 percent of the one class of stock of foreign corporation A. The remaining 90 percent of Corporation A's stock is owned by Corporation Z, a foreign corporation. Corporation A is not a controlled foreign corporation and uses the u as its functional currency. 1u equals \$1 at all relevant times. Both Corporation A and Corporation M use the calendar year as the taxable year. Corporation A has pre-1987 accumulated profits or deficits in accumulated profits and post-1986 undistributed earnings, pays post-1986 foreign income taxes, and pays dividends as summarized below:

Taxable year	1986	1987	1988	1989	1990
Current E & P (Deficits) of Corp. A	(100u)	150u	(150u)	100u	250u
Current Plus Accumulated E & P (Deficits) of Corp. A	(100u)	50u	(200u)	(100u)	50u
Post-'86 Undistributed Earnings of Corp. A		50u	(200u)	(100u)	50u

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Post-'86 Undistributed Earnings of Corp. A	(50u)	(200u)	(200u)	0
Reduced By Current Year Dividend Distributions (reduced by deficit carryforward).				
Foreign Income Taxes (Annual) of Corp. A	0	\$120	0	\$50
Post-'86 Foreign Income Taxes of Corp. A	0	\$120	0	\$50
12/31 Distributions to Corp. M	0	10u	0	10u
12/31 Distributions to Corp. Z	0	90u	0	90u

(ii) On December 31, 1987, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. At the time of the distribution, Corporation A has 50u of post-1986 undistributed earnings and 150u of current earnings and profits. Thus, 50u of the dividend distribution (5u to Corporation M and 45u to Corporation Z) is a dividend out of post-1986 undistributed earnings. The remaining 50u is a dividend out of current earnings and profits under section 316(a)(2), but Corporation M is not deemed to have paid any additional foreign income taxes paid by Corporation A with respect to that 50u dividend out of current earnings and profits. See § 1.902-1(b)(4). Note that even if there were no current earnings and profits in Corporation A, the remaining 50u of the 100u distribution cannot be deemed paid out of accumulated profits of a pre-1987 year because Corporation A has an accumulated deficit as of the end of 1986 that eliminated all pre-1987 accumulated profits. See paragraph (b)(2) of this section. Corporation A has \$120 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend out of post-1986 undistributed earnings are \$12 (\$120×10%[5u/50u]). Corporation M includes this amount in gross income as a dividend under section 78. Both the foreign taxes deemed paid and the deemed dividend are subject to a separate limitation for dividends from noncontrolled section 902 corporation A. As of January 1, 1988, Corporation A has (50u) in its post-1986 undistributed earnings (50u-100u) and -0- in its post-1986 foreign income taxes, \$120 reduced by \$120 of foreign taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the dividend distributed by Corporation A out of post-1986 undistributed earnings (\$120×100%[50u/50u]).

(iii) On December 31, 1989, Corporation A distributes a 10u dividend to Corporation M and a 90u dividend to Corporation Z. Although the distribution is considered a dividend in its entirety out of 1989 earnings and profits pursuant to section 316(a)(2), post-1986 undistributed earnings are (100u). Accordingly, for purposes of section 902, Corporation M is deemed to have paid no post-1986 foreign income taxes. See § 1.902-1(b)(4). Corporation A's post-1986 undistributed earnings as of January 1, 1990, are (200u) ((100u)-100u). Corporation A's post-1986 foreign income

taxes are not reduced because no taxes were deemed paid.

(iv) On December 31, 1990, Corporation A distributes a 5u dividend to Corporation M and a 45u dividend to Corporation Z. At that time Corporation A has 50u of post-1986 undistributed earnings, and \$150 of post-1986 foreign income taxes. Foreign taxes deemed paid by Corporation M under section 902 with respect to the 5u dividend are \$15 (\$150×10%[5u/50u]). Post-1986 undistributed earnings as of January 1, 1991, are -0- (50u-50u). Post-1986 foreign income taxes as of January 1, 1991, also are -0-, \$150 reduced by \$150 (\$150×100%[50u/50u]) of foreign income taxes that would have been deemed paid if both Corporations M and Z were eligible to compute an amount of deemed paid taxes on the 50u dividend.

[T.D. 8708, 62 FR 937, Jan. 7, 1997, as amended by T.D. 9260, 71 FR 24526, Apr. 25, 2006; 71 FR 77265, Dec. 26, 2006]

§ 1.902-3 Credit for domestic corporate shareholder of a foreign corporation for foreign income taxes paid with respect to accumulated profits of taxable years of the foreign corporation beginning before January 1, 1987.

(a) *Definitions.* For purposes of section 902 and §§ 1.902-3 and 1.902-4:

(1) *Domestic shareholder.* In the case of dividends received by a domestic corporation after December 31, 1964, from a foreign corporation, the term "domestic shareholder" means a domestic corporation which owns at least 10 percent of the voting stock of the foreign corporation at the time it receives a dividend from such foreign corporation.

(2) *First-tier corporation.* In the case of dividends received by a domestic shareholder after December 31, 1964, from a foreign corporation, the term "first-tier corporation" means a foreign corporation at least 10 percent of the voting stock of which is owned by a domestic shareholder at the time it receives a dividend from such foreign corporation. The term "first-tier corporation" also means a DISC or former DISC, but only with respect to dividends from the DISC or former DISC to